Overview

In 2004, the U.S. economic recovery blossomed into a full-fledged expansion, with strong output growth and steady improvement in the labor market. Real gross domestic product (GDP) grew by 4.4 percent in 2004 for the year as a whole. About 2.2 million new payroll jobs were created during 2004—the largest annual gain since 1999. The unemployment rate fell to 5.4 percent by year's end, below the average of each of the past three decades. Inflation remained moderate, especially excluding volatile energy prices. The U.S. economy is on a solid footing for sustained growth in the years to come.

This is a marked reversal from the economic situation the Nation faced when President Bush came into office. Four years ago, the economy was sliding into recession after the bursting of the high-tech bubble of the 1990s. The economy was then affected by revelations of corporate scandals, slow growth among our major trading partners, and the terrorist attacks of September 11, 2001. Business investment slowed sharply in late 2000 and remained soft for more than two years. The economy lost over 900,000 jobs from December 2000 to September 2001, and then almost another 900,000 jobs in the three months after the 9/11 attacks.

Prompt and decisive policy actions helped to counteract the effects of these adverse shocks to the economy. Substantial tax relief together with expansionary monetary policy provided stimulus to aggregate demand that softened the recession and helped put the economy on the path to recovery. In addition to providing timely short-term stimulus, the President's pro-growth tax policies have improved incentives for work and capital accumulation, thereby fostering an environment conducive to long-term economic growth.

This *Report* discusses macroeconomic developments of the past year, the Administration's forecast for the years to come, and several topics related to salient economic issues.

The Year in Review and the Years Ahead

Chapter 1, *The Year in Review and the Years Ahead*, reviews economic developments in 2004 and discusses the Administration's forecast for 2005 to 2010. Solid economic growth continued in 2004, and the Administration's forecast calls for further expansion in 2005, with real GDP growing faster than its historical average and the unemployment rate continuing to decline. The economy is expected to continue on a path of strong, sustainable growth.

Real GDP expanded by 3.7 percent during the four quarters of 2004, and by 4.4 percent for the year as a whole compared with 2003. The solid advance in real GDP during 2004 was supported by gains in consumer spending, business fixed investment, and, to a lesser extent, housing investment, inventory accumulation, and government spending. Net exports (exports less imports) held down growth in all four quarters as the trade deficit rose in the third quarter to a record high as a percentage of GDP. Progress toward strengthened economic growth among U.S. trading partners led to an increase in exports, but imports continued to outpace exports as U.S. domestic demand and demand for imported oil remained strong. The economy's strong growth performance came about in the face of higher oil prices, which likely reduced growth somewhat during the year. The Administration expects real GDP to grow 3.5 percent during the four quarters of 2005, in line with the consensus of professional forecasters. This growth is expected to be driven by continued gains in consumer spending, investment growth, and stronger net exports.

The labor market strengthened during the year. The unemployment rate, which declined 0.5 percentage point to 5.4 percent by the end of 2004, is projected to edge down further to 5.3 percent by the fourth quarter of 2005. Nonfarm payroll employment, which grew about 180,000 per month during 2004, is projected to grow about 175,000 per month in 2005, in line with other professional forecasts.

Inflation increased from the extremely low levels of 2003, partly because of rapid increases in energy prices. Inflation as measured by the consumer price index excluding food and energy remained in the moderate 2 percent range, and inflation expectations remain low.

The economy made these advances even as energy prices soared, the Federal Reserve raised interest rates, and the demand-side effects of fiscal policy stimulus began to recede in the second half of 2004. This continued growth indicates that the economy has shifted from a policy-supported recovery to a self-sustaining expansion.

Expansions Past and Present

Chapter 2, *Expansions Past and Present*, compares the current economic expansion to previous expansions. The current expansion and the previous one that started in 1991 followed especially shallow recessions, and both exhibited relatively moderate overall growth in key economic variables. Shallow recessions typically are followed by shallow recoveries and deep recessions by robust recoveries. The recent recession stands out in that there were no consecutive quarters of decline, with revised data showing that real GDP dropped in the third quarter of 2000 and the first and third quarters of 2001, but grew in the intervening quarters.

Consumption and residential investment continued to grow throughout the recession, while business investment fell sharply in the recession and continued to decline for five quarters after the overall economy had bottomed out. Both of these developments likely reflect the important role of fiscal and monetary stimulus in supporting household demand and the unusual extent to which the recession resulted from a collapse in investment following the bubble of the late 1990s. The relationship between firms' abilities to invest and the state of economic activity has been deemed the "financial accelerator," in that changes in activity affect firms' ability to invest and this in turn further affects activity, in a way that tends to accentuate economic fluctuations. Fiscal and monetary policy actions have counterbalanced these forces. Without the boost to disposable income from tax relief, the recession would have been deeper and longer.

The relatively weak payroll employment growth in the initial stages of the current expansion likely reflects both the shallowness of the recession and the unusually strong growth of productivity in the recession and expansion. In an average expansion before the 1990s, employment recovered along with output at the start of the expansion and regained its previous peak about three quarters after the trough. In the expansion of the 1990s, however, employment continued to fall for two quarters after the expansion had commenced and did not reach its previous peak value until another six quarters had passed. In the most recent expansion, employment continued to fall for seven quarters after the recession had ended and regained its prerecession level only at the beginning of 2005, some 12 quarters after the end of the recession.

The moderate employment growth reflects especially strong productivity growth during the current expansion. Productivity growth has averaged 4.2 percent per year at an annual rate in the most recent expansion, up substantially from the 2.5 percent growth rate seen on average from 1995 to 2000. In the short run, greater productivity growth sets the bar higher for employment growth. With increased productivity, a given amount of output can be produced with fewer hours worked, so real GDP must grow more quickly for employment to grow. In the long run, however, higher productivity growth leads to higher income per person, and will thus be expected to be positive for employment growth.

That the recent recessions and expansions have been especially moderate suggests the possibility that the economy has become more stable in general. If so, then part of this stability is likely attributable to more active and timelier stabilization policy. Other factors possibly contributing to a more stable economy include improved inventory management that lessens the volatility of production changes, and the ongoing shift in the U.S. economy toward the service sector, the output of which has typically been more stable than the production of goods.

Options for Tax Reform

Chapter 3, *Options for Tax Reform*, discusses why tax reform is vital to a stronger economy, and examines several basic prototypes for reform. The President has not endorsed any specific proposal, and the chapter does not advocate the adoption of any particular prototype for reform.

The current Federal tax system is unnecessarily complex and distorts incentives for work, saving, and investment. In addition to the dollar amounts of taxes paid, the tax system imposes two indirect burdens on taxpayers and on the U.S economy as a whole: the costs (in time and money) of complying with tax rules and the costs (including slower economic growth) of tax-induced distortions of economic activity. The Internal Revenue Service estimated that for tax year 2000, individual taxpayers spent 3.2 billion hours on tax compliance, an average of 25.5 hours per return, and spent $19 billion on tax preparers, computer software, and similar expenses.

High tax rates reduce incentives for work, saving, and investment, distort economic decisions, and divert resources from productive activity into tax avoidance, ultimately reducing economic growth and lowering living standards. High tax rates lead people to work less, to take their compensation in nontaxable forms such as health insurance, and to alter their portfolios to focus on tax-favored investments. The current tax system also distorts many business decisions, resulting in inefficient use of resources and reduced economic output. Double taxation of corporate income raises the cost of capital and would therefore be expected to have an adverse effect on investment. Double taxation further leads firms to finance investment with debt instead of equity, creates a bias in favor of using business forms such as partnerships and subchapter S corporations that are not subject to the double tax, and discourages paying dividends. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced this double tax by reducing the individual income tax rates for both dividends and capital gains, and appears to have led to a sizable increase in dividend payments by firms.

Tax reform proposals generally follow either the principle of taxing consumption or the principle of reforming the existing system to conform more closely to a pure income tax.

Most proposals for tax reform involve variations on a few basic types of taxes. The main types of consumption taxes are the retail sales tax, the value added tax, the flat tax, and the consumed income tax. The *retail sales tax* imposes tax liability when an individual purchases goods or services for consumption, whereas the *value added tax* levies tax on the same base but the tax is collected instead on the value added to the good or service at each stage of its production. The *flat tax* consists of a business tax and an individual-level tax, both with a single flat tax rate, in which wages are taxed at the individual level rather than being included in the business tax base. This allows for building progressivity into the system by providing an exemption of, say, $40,000 for a family of four. While these taxes appear to be quite different, they are equivalent from an economic standpoint because consumption is the overall tax base in each case.

Important benefits could also be obtained through simplification and reform of the current tax system. A reformed version of the current system would reduce transition and adjustment costs, and considerable benefits could be obtained by simplifying and rationalizing tax provisions that overlap or are otherwise overly complex.

The Administration's tax program has already significantly reformed the tax system. Achievements include lowering marginal tax rates, reducing the double tax on corporate income, simplification, and improved fairness for families. The tax relief passed during the President's first term also increased the overall progressivity of the Federal tax system. The bottom 40 percent of the population in terms of income received the largest percentage reductions in total Federal taxes, and the share of taxes paid by the top 20 percent in terms of income increased as a result of the tax cuts enacted since 2001.

Possible additional reforms would be to lower tax rates further and broaden the base; rationalize the current multitude of saving incentives; further reduce or eliminate the remaining double taxation of corporate income; and simplify the complex system of depreciation rules. Reform within the current system would also address the Alternative Minimum Tax (AMT), which adds considerable complexity, and which, under current law, is expected to affect a rapidly growing number of taxpayers over the next five years.

Although tax reform has been discussed for many years, it is a particularly pressing need at the current time. Increasing numbers of taxpayers will be affected by the Alternative Minimum Tax, which will be a major source of frustration and complexity. In addition, the tax reductions enacted since 2001 will expire in a few years unless they are extended or a new, reformed tax system is adopted. If these provisions are allowed to expire, the result will be substantial increases in taxes on taxpayers in all income groups, with the largest percentage increases being imposed on lower- and middle-income households.

Immigration

Chapter 4, *Immigration*, examines the economic impact and implications of immigration. In recent decades, the United States has experienced a surge in immigration not seen in over a century. Immigration has touched every facet of the U.S. economy and, as the President has said, America is a stronger and better Nation for it. A comprehensive accounting of the benefits and costs of immigration shows that the benefits of immigration exceed the costs.

Immigrants have settled in all parts of our Nation and have generally succeeded in finding jobs quickly, helped in large measure by the flexibility of the U.S. labor market. One indicator of this success is that foreign-born workers in the United States have a higher labor force participation rate and a lower unemployment rate than foreign workers in most major immigrant-receiving countries.

While flexible institutions may speed the economic integration of the foreign-born, the distribution of the gains from immigration can be uneven. Less-skilled U.S. workers who compete most closely with low-skilled immigrants have experienced downward pressure on their earnings as a result of immigration, although most research suggests these effects are modest. Also, communities contending with a large influx of low-skilled immigrants may experience an increased tax burden as immigrant families utilize publicly provided goods such as education and health care.

U.S. immigration policy faces a complicated set of challenges, perhaps more so now than ever before. Policy should preserve America's traditional hospitality to lawful immigrants and promote their economic contributions. Yet these goals must be balanced with the Nation's many needs, including the imperative for orderly and secure borders. These challenges have only grown in a post-9/11 world. The persistence of undocumented immigration and problems with employment-based immigration suggest that current policy falls short in addressing the demand for immigrant workers and the need for national security. The President's proposed Temporary Worker Program recognizes these problems and would implement necessary reforms.

Expanding Individual Choice and Control

Chapter 5, *Expanding Individual Choice and Control*, examines the role played by property rights in providing the link between people's effort and their reward. Having property rights allows people to know that they will reap the rewards of their efforts and entrepreneurship.

When used in economics, the term *resource* refers not just to natural resources, such as land or clean air, but to anything of value, such as skills. A *property right* refers broadly to the arrangements society uses to assign people control over resources. Property rights have a variety of names, including deeds, titles, permits, vouchers, allowances, or accounts. Patents and copyrights are also property rights, establishing control over inventions, books, songs, and other creative concepts. The essential idea is the same in each case: the owner of the property right controls how something valuable is used.

That control is defined using a bundle of specific rights. The bundle is commonly thought to consist of three main elements: the right to exclusive use of the resource, the right to income derived from the resource, and the ability to transfer those rights. Property rights can include a range of those elements, from weak rights (which might only include the right to use the resource) to strong rights in all three elements.

Property rights have a profound effect on the choices people make. In addition to giving them the incentive to maintain and invest in things, people will use resources more prudently if they own them. Property rights are essential for markets to function. The lack of a clear title might prevent a car purchase. A home buyer is unlikely to sign on the dotted line if she is not sure that the seller actually owns the house. Without property rights, would-be entrepreneurs cannot secure loans they might need to help their businesses grow.

Property rights are essential to the efficient operation of markets, which in turn allocate resources to their most highly valued use. Clearly defined rights are important in avoiding overuse of resources and in encouraging the improvement of resources. Property rights further provide incentives to invest in, maintain, and improve resources over time. The benefits of homeownership come about because individuals have control and responsibility over their property and their lives.

The thoughtful application of property rights has already brought about a number of policy improvements. Introducing a property-rights regime for air quality reduced emissions almost 30 percent more than the required level and achieved annual cost savings estimated at hundreds of millions of dollars per year. The use of property rights for fisheries has mitigated overfishing while increasing commercial fishermen's profits and promoting a more stable industry. The application of property rights to education has facilitated greater school choice and improved student performance. These uses of property rights have given control to people with the best information and incentives to use the resources in question.

Providing people with ownership, individual choice, and control of assets could help address several current concerns. Giving families more control over their retirement by establishing personal retirement accounts they actually own would improve the Social Security system. Offering people greater control over the money used for their health care would reduce health care spending and increase the number of people with health care insurance. Providing countries greater ownership (that is, more control) over how they use the development assistance they receive will make them active partners in the programs funded.

Innovation and the Information Economy

Chapter 6, *Innovation and the Information Economy,* provides an overview of recent developments in information technology and discusses some of the economic issues relevant to this especially dynamic sector of the economy. Innovation and information technology are increasingly key contributors to economic growth and productivity. Our Nation's growing prosperity depends on fostering an environment in which innovation will flourish.

Information technology has made many workplace tasks easier, boosting people's productivity. One recent study finds that labor productivity in the nonfarm business sector grew at an annual rate of 2.4 percent from 1996 through 2001, and attributes nearly three-quarters of this growth to the accumulation of information technology capital together with improvements in how people use this capital. Of the 2.9 percent growth in real gross domestic product (GDP) in 2003, some 0.8 percentage point was attributable to information technology.

A key development of the growing information economy is that more people are using computers and communicating over the Internet. Usage of the Internet includes email and the rapid growth of e-commerce, which includes transactions with consumers and transactions between businesses. Consumers have benefited from e-commerce through the greater variety of goods available online and through the additional competition and lower prices resulting from the spread of e-commerce. A downside is the rise of online theft, vandalism, and fraud. The Administration has taken actions to protect property rights and ensure that the Internet and other new technologies are safe venues for commerce.

The process by which innovations such as the Internet come about involves the invention, commercialization, and diffusion of new ideas. At each of these stages, people are spurred to action by the prospect of reaping rewards from their investment. Government thus has an important role to play in defining and protecting property rights in intellectual and physical capital so that entrepreneurs will be spurred to innovate.

In a free market, innovators vie to lower the cost of goods and services, to improve their quality and usefulness, and—most importantly—to develop new goods and services that promise benefits to customers. An innovation will succeed if it passes the market test by profitably delivering greater value to customers. Successful innovations blossom, attracting capital and diffusing rapidly through the market, while unsuccessful innovations can wither just as quickly. In this way, markets allow capital to flow to its highest-valued uses. Competition drives the broad diffusion of innovative low-cost, high-quality information services. This has held true in markets for mobile wireless telephones, satellite television, and dial-up and broadband Internet services.

This engine of growth can falter, however, if government policies distort the market signals that guide innovative activity. Well-meaning policies to promote the diffusion of a service or foster entry into new markets can have unintended consequences. A policy to subsidize an existing service so that more people will consume it can deter development of innovative new services that people might otherwise prefer. In addition, potential pioneering investors forced to share the fruits of their investment with new entrants would find it less profitable to invest in the first place, and a new market may never be developed. As circumstances change and industries evolve, existing government regulations may need rethinking. In particular, economic regulations aimed at correcting an absence of competition may lose their rationale when competition from new technologies emerges.

The Global HIV/AIDS Epidemic

Chapter 7, *The Global HIV/AIDS Epidemic,* examines the economic issues posed by the acquired immunodeficiency syndrome (AIDS) epidemic. The disease has already killed over 25 million people, and currently over 40 million people are living with the human immunodeficiency virus (HIV), the virus that causes AIDS. The chapter discusses the nature of the crisis, its consequences, and what governments can do to create affordable access to existing treatments while encouraging research toward the development of new medical therapies to combat this disease.

The impact of HIV/AIDS varies across the world, both in terms of the scale of the epidemic and the ability to treat infected individuals. Less-developed countries are particularly hard hit on both accounts. Almost two thirds of all people with HIV live in sub-Saharan Africa, a region that makes up only one tenth of the world's population. At the same time, few infected individuals in the region receive adequate treatment for the disease.

While the disease's impacts on human health and mortality are widely recognized, the HIV/AIDS epidemic also has devastating economic consequences that exacerbate the humanitarian crisis. AIDS deepens poverty, intensifies food shortages, and, in some cases, erases decades of economic progress. HIV/AIDS-related illnesses directly decrease the income of an affected household. Even if an infected family member is able to work, a sick worker is likely to be less productive than a healthy one. The disease predominantly affects the working-age population, and thus can leave too few people to support the aging and young populations. AIDS can also impose debilitating costs on other members of a household, for example as other family members may need to miss work or school to care for a patient. The disease can further change the way that affected families make long-term decisions, because they do not expect family members to live as long and because their needs become more immediate due to pressing health concerns. As a result, children may be pulled out of school in order to supplement the declining family income, resulting in a loss in the children's future earning potential. Impacts such as this can combine to create a vicious cycle of increased poverty in the short run and an inability of households to improve their condition in the long run.

The President has made fighting the worldwide HIV/AIDS epidemic a priority of U.S. foreign policy. He has taken bold action against the crisis through his Emergency Plan for AIDS Relief. Understanding the unique challenges presented by this epidemic is essential to designing policies to prevent the spread of the disease and to treat those who are already infected. A comprehensive and integrated approach of prevention, treatment, and care is essential to quelling the epidemic. In poor countries, treatment affordability and the lack of health care infrastructure are major concerns. Compassionate pricing policies and aid from developed nations can play an important role in expanding access to treatment.

To continue the development of better treatments and to work toward eradication of HIV/AIDS, drug companies need to maintain the highest possible quality of research. Intellectual property laws are important to ensuring appropriate incentives for innovation to create the next generation of therapies and to develop a safe and effective vaccine.

Modern International Trade

Chapter 8, *Modern International Trade*, examines the benefits of free trade and discusses the progress the Administration has made in opening global markets. Open markets and free trade raise living standards both at home and abroad. Any move toward economic isolationism would threaten the competitive gains made by U.S. exporters while harming U.S. consumers and firms that benefit from imports.

The President's policy of opening markets around the world is based on a long history of intellectual support for free trade, starting with the nineteenth century theory of comparative advantage advanced by David Ricardo. Ricardo illustrated the ways in which free trade allows countries to mutually benefit from specializing in producing products at which they are adept and then exchanging those products. This rationale remains the same, even with advances in technology and new types of trade. The principle of comparative advantage applies to the burgeoning trade in services, in which the performance of U.S. service workers and firms has been particularly strong. The United States exports more services than it imports, and this surplus has been growing in recent years. Moreover, U.S. services exports tend to involve relatively highly skilled and highly paid occupations, such as engineering, financial services, or architectural services.

Richer economic models that take into account the features of the modern world show that countries as a whole still gain from free trade. There are, however, differing impacts of trade on different parts of the economy and the labor force. Policies aimed at supporting individuals affected by trade are thus vital to ensuring that its gains are widely shared. To this end, the Administration has proposed a reform of the overall workforce training system to help Americans obtain marketable skills needed to compete for jobs in emerging and innovative fields. The Administration recognizes that effective workforce training requires the cooperation of the private sector and community colleges and has worked to nurture these partnerships through the High Growth Job Training Initiative at the Department of Labor and through the recently enacted Community-based Job Training Grants. In addition, the Administration has proposed the establishment of Personal Reemployment Accounts, an innovative approach to worker retraining, and has worked to enhance the long-standing Trade Adjustment Assistance program, which provides training and income support to workers directly hurt by import competition. As part of the Trade Act of 2002, eligibility was extended to workers indirectly affected by trade, such as workers employed by firms that supply goods and services to industries directly affected by trade competition. Benefits were enhanced to include a health insurance tax credit and a wage supplement for older workers who found new jobs that did not pay as well as their previous jobs. This assistance, which will total $12 billion over 10 years, will ease the adjustment for displaced workers and help them move into jobs for which their skills are most in demand.

Foreign direct investment is playing an increasingly important role in world trade, as companies invest across borders to gain skills, technology, resources, and market access. A good deal of evidence suggests that increased employment at the foreign subsidiaries of U.S. firms is associated with a corresponding increase in employment in the U.S. parent company. Similarly, recent research shows that one dollar of spending on capital investments abroad by U.S. firms is associated with an additional three and a half dollars of spending on capital investment at home. The available evidence thus suggests that, on the whole, overseas expansion by U.S. firms goes hand-in-hand with expansion at home. Subsidiaries of foreign firms operating in the United States make important positive contributions to the U.S. economy as well. Foreign direct investment into the United States is associated with the adoption of new technology, techniques, and skills by locally-owned companies. U.S. subsidiaries of foreign companies employed 5.4 million U.S. workers in 2002, nearly 5 percent of total private-sector employment. This is up from 3.9 million workers in 1992 (4.3 percent of total private employment at that time).

The Administration has pushed aggressively to open global markets to trade through multilateral talks under the auspices of the World Trade Organization (WTO), and through agreements to liberalize trade between the United States and various partners. The Administration has worked to ensure that the benefits promised under the agreements are realized for U.S. consumers, workers, manufacturers, farmers, and service providers. At the same time, lower trade barriers benefit people in U.S. trading partner countries. When U.S. trading partners do not fulfill their obligations, the Administration has sought their compliance through a practical, problem-solving approach. When that fails, however, the Administration has utilized formal dispute-settlement mechanisms.

The integration of the Chinese economy into the global trading system has been an important development in recent years. The Administration has worked to ensure that China lives up to the agreements it has signed, including lowering its barriers to trade, addressing concerns about intellectual property protection, and adopting and enforcing the rules of the multilateral trading regime. Trade between the United States and China has been growing rapidly. For goods trade through November 2004, China ranked as the third-largest trading partner of the United States. For most of the period since China's WTO accession, U.S. exports to China have been growing at a rate faster than its imports from China, but this export growth is occurring from a much smaller base.

The Administration's vigorous pursuit of trade liberalization has paid off in progress on the Doha Development Agenda. The United States played a leading role in the intensive negotiations that led to an agreement establishing a framework for the ongoing talks at the WTO. These talks, which were launched in 2001 in Doha, Qatar, have focused on measures that will especially benefit developing nations, including the elimination of agricultural export subsidies. Trade agreements were also concluded in 2004 with Australia, Morocco, Bahrain, and with the participants in the Central American Free Trade Agreement (CAFTA), including Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic. At the same time, the United States continued negotiations with the five nations of the Southern African Customs Union (Botswana, Lesotho, Namibia, South Africa, and Swaziland) while launching new negotiations with Thailand, Panama, and the Andean nations Colombia, Ecuador, and Peru. The President has also announced to Congress his intention to begin free trade agreement negotiations with the United Arab Emirates and Oman. When combined with agreements already negotiated by the Administration, partner countries accounting for almost $50 billion in 2003 trade have committed to eventually eliminate tariffs on almost all U.S. exports. Tariffs that averaged as high as 19.6 percent for U.S. exports will be reduced to zero as a result of these agreements.

Conclusion

The last year has seen the U.S. economy strengthen from recovery into a solid and sustainable expansion. With the near-term outlook bright, this provides an opportunity to put renewed focus on longer-term economic challenges. The President's agenda is focused on these challenges—on taking the actions needed to bring about a better economic future shared by all Americans. The President's policies are designed to foster rising living standards at home, while encouraging other nations to follow our lead.